

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:PNX:TL-N-3534-01
JWDuncan

date:

to: William Kennedy, Manager, Group 1282, M/S 4201PHX
Attn: Mark Nutter

from: Office of Chief Counsel, Phoenix
LMSB:NR, Area 4

subject: [REDACTED]
Effect of bankruptcy on [REDACTED]

This memorandum supplements our memorandum of June 19, 2001 in response to your request for assistance dated May 24, 2001. This memorandum should not be cited as precedent.

In our prior memorandum, we rendered advice regarding the effect of the taxpayer's bankruptcy on your examination of the [REDACTED]. Our national office has confirmed the correctness of the conclusions set forth in our June 19 memorandum. In doing so, they have recommended that we revise the rationale behind our conclusion regarding the second enumerated issue.

In agreeing that further examination under TEFRA procedures is unnecessary, the national office believes that once [REDACTED] filed for bankruptcy, it was removed from the TEFRA proceeding pursuant to Treas. Reg. § 301.6231(c)-7T. Because the L.L.C., the only other partner, is a pass-through entity with its only member in bankruptcy, there are no other taxable entities involved; thus, a TEFRA procedure is no longer warranted under these facts.

If you have any questions regarding the above, please contact the undersigned at (602) 207-8052. As it appears that no further action is presently required of this office in this matter, we are hereby closing our file.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JOHN W. DUNCAN
Attorney

Office of Chief Counsel
Internal Revenue Service

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Effect of bankruptcy on

This memorandum responds to your request for assistance dated May 24, 2001. This memorandum should not be cited as precedent.

Issues

1. What partnership items of the partnership have converted to nonpartnership items?
2. If all partnership items have converted to nonpartnership items, what is procedurally required in the examination of such items?
3. What is the relevant limitations period for assessment of taxes resulting from any determination regarding partnership items which have converted to nonpartnership items?

Conclusions

1. All partnership items have converted to nonpartnership items.
2. Further examination under TEFRA procedures is unnecessary. Further examination of the partnership return should be done in a fashion that, if the issues are not resolved, would result in a notice of deficiency to [REDACTED].
3. Although current law appears to provide that the relevant limitations period is the longer of the § 6501 period or one year from the filing of the bankruptcy petition, (b)(7)a [REDACTED].

Facts

During your examination of the consolidated group's returns, you determined that the Service should likewise examine the returns of [REDACTED]. This partnership has two partners: 1) [REDACTED], and 2) a limited liability corporation (LLC) which has [REDACTED] as its sole member. [REDACTED] is the parent corporation of [REDACTED]; the [REDACTED] files a consolidated return under § 1501 and Treas. Reg. § 1.1502-1 et seq. Under the circumstances, which we will not spell out in this memorandum, you determined that the examination of the partnership returns should be conducted under the so-called TEFRA procedures set forth in I.R.C. § 6221 et seq. By written memorandum reviewed by our national office, we agreed that TEFRA provided the correct procedures for this examination, a conclusion which has been again confirmed in our recent discussions with national office personnel regarding this matter.

On [REDACTED], the parent corporation and several subsidiaries, including [REDACTED], filed Chapter 11 bankruptcy petitions. As you know, the filing of a bankruptcy petition can have an effect on a TEFRA examination. You have therefore asked that we set forth the effects of the bankruptcy filings on the partnership, and discuss how you should, or in some cases, must, modify your approach to the examination of the partnership returns because of the bankruptcy.

Discussion

1. As you know, a partner's bankruptcy converts the partnership items of that partner to nonpartnership items. I.R.C. § 6231(c)(1)(E); Temp. Treas. Reg. § 301.6231(c)4T-8T. This conversion affects the procedures which the Service must follow in order to make a valid adjustment to a bankrupt partner's liability. It does not affect the standards under which the partnership return will be viewed. In other words, the conversion from partnership item to nonpartnership item is procedural, not substantive. The correctness of the partnership return must still be determined under the relevant substantive provisions regarding partnership returns. Once such determinations are made, however, they will be handled procedurally as to the bankrupt partner as if they were adjustments to its individual return.

Thus, in a TEFRA partnership in which one partner files for bankruptcy, the Service would continue its examination of the partnership return under TEFRA procedures. The main difference is that the bankrupt partner would get a separate report, since his share of the adjustments are nonpartnership items. The bankrupt partner would likewise not be part of any subsequent proceedings regarding adjustments to partnership items, such as protests or petitions to Tax Court (see, e.g., § 6226(d)(1)(A), providing that a bankrupt partner is not a partner in a court action brought under § 6226), but instead would have to proceed separately since his adjustments are procedurally treated as nonpartnership items.

In the present case, [REDACTED] filed a bankruptcy petition on [REDACTED]. Its share of partnership items therefore converted to nonpartnership items on that date, and such items are no longer subject to the TEFRA procedures.

That leaves the question of whether the items of the LLC have converted to nonpartnership items. The LLC is a flow-through entity. Indeed, on the return for the consolidated group, it appears to be disregarded entirely for tax purposes. Its sole member, [REDACTED], has filed a bankruptcy petition. The relevant question therefore is whether the bankruptcy of the sole member of a flow-through entity results in conversion of the entity's partnership items to nonpartnership items.

In that regard, we note that as to the LLC, [REDACTED], as the sole member of the LLC, is an "indirect partner" as defined in § 6231(a)(10). It holds an interest in a pass-through partner (the LLC), and because of this interest has an indirect interest in the LLC's interest in the [REDACTED]. The Service's position is that an event personal to an indirect partner will convert the indirect partner's partnership items relating to the source partnership into nonpartnership items. To state this another way, the bankruptcy of [REDACTED] causes its share ([REDACTED]%) of the LLC's partnership items from [REDACTED] to convert to nonpartnership items. This is consistent with the rationale stated in Third Dividend/Dardanos Associates v. Commissioner, 88 F.3d 821, 823 (9th Cir. 1996). In that case, the facts were the opposite of the present situation. The flow-through entity (an S corporation) which held a partnership interest was in bankruptcy, while the underlying owners of the flow-through entity were not. The Service attempted to assert that the owners of the S corporation were not entitled to contest adjustments made to the partnership of which the S corporation was an owner. The court disagreed, holding that it was the

shareholders, not the S corporation, that would ultimately be liable for any tax liability arising from the partnership, and that such liability gave the shareholders an interest in the partnership. See also Dionne v. Commissioner, T.C. Memo. 1993-117. In that case an individual was a shareholder in an S corporation which held an interest in a partnership. The individual shareholder filed for bankruptcy. The court held that even though the S corporation, not the individual, was the partner, the individual was deemed a partner because of the pass-through nature of the S corporation. The court therefore determined that the S corporation's share of partnership items became nonpartnership items of the individual shareholder, due to the individual shareholder's bankruptcy.

In the present case, although the LLC is the partner rather than [REDACTED], the LLC is a flow-through entity, with everything flowing through to [REDACTED]. Under the principles discussed above, the LLC's share of partnership items converts to nonpartnership items of its single member, [REDACTED], due to the bankruptcy of [REDACTED].

This means that all partnership items of the partnership have converted to nonpartnership items, since 1) [REDACTED] is a direct partner of a [REDACTED] interest in the partnership, 2) [REDACTED] is an indirect partner over the remaining [REDACTED] partnership interest, and 3) the bankruptcy of [REDACTED] has converted the partnership items for its direct and indirect interests in the partnership into nonpartnership items.

2. Because all partnership items have converted to nonpartnership items, there are presently no issues remaining which might properly be the subject of the TEFRA procedures, and no issues which would properly be includible in an FPAA. We therefore see no purpose in continuing with a TEFRA examination, and recommend that you advise the taxpayer that you are closing the TEFRA examination for this reason.

We nonetheless point out that in advising you to close the TEFRA examination, we are not suggesting that you stop examining the partnership returns. As indicated above, the TEFRA rules are procedural rules which are to be used in examining the returns of certain partnerships. The fact that the TEFRA rules do not apply to certain partnership returns does not affect the Service's ability to propose adjustments from such returns; it just means that the Service's determinations would ultimately be set forth in something other than an FPAA, specifically, notices of deficiency to the individual partners. See I.R.C. S 6230(a)(2)(A)(ii). As for the administrative steps for getting to that point, we do not view it as critical that any particular

procedure be followed, so long as the procedure followed does not deprive the taxpayer ([REDACTED]) of any rights normally associated with the Service's examination of a taxpayer's return. For example, we believe that your audit determinations regarding the partnership may be presented to the taxpayer either as part of your report regarding the Form 1120, or as a separate report, so long as the taxpayer is somehow presented with your determinations and has the normal opportunity to contest such determinations.

(b)(7)a

[REDACTED]

3. As you know, I.R.C. § 6229(f)(1) provides that when partnership items convert to nonpartnership items, the period for assessing any tax attributable to such items "shall not expire before the date which is 1 year after the date on which the items become nonpartnership items." In the present case, this period would expire on [REDACTED].

The Service believes that this period is an alternative to the taxpayer's ([REDACTED] 's) normal limitations period, as extended, under I.R.C. § 6501. In other words, if a limitations period under § 6501 expires on [REDACTED], and the period under § 6229(f)(1) expires on [REDACTED], the Service would have until [REDACTED] to assess tax attributable to the converted items; if the § 6501 period expired instead on [REDACTED], then the Service would have until [REDACTED] to make such assessment. Indeed, the Service has litigated this position successfully in Rhone-Poulenc Surfactants and Specialties, L.P. v. Commissioner, 114 T.C. 533 (2000) (appeal pending). In that case, the court held that § 6229(f)(1) provided an alternative, rather than substitute, period of limitations, and that § 6229 does not preclude the applicability to specific partners of a

longer period under § 6501.

(b)(7)a

. We understand that Form 872-F has been designed for this purpose. We therefore recommend that for protective purposes, you solicit from the taxpayer Forms 872-F for all periods in which you believe the Service might consider adjustments due to converted items.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum to allow the Division Counsel (Large and Mid-Size Business) an opportunity to comment. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

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JOHN W. DUNCAN
Attorney